MORNING EDITION | May 11, 2015

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Risk-Adjusted Return Monitor

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*Highlights the largest positive and negative risk-adjusted returns overnight.

Summary & Views

Professionals Looking at Fallout from Weaker US Growth Profile...Not the Cleanest Dirty Shirt Anymore

- Portfolio Overlay: S&P 500 Strangle
- US Data Update
- US Financials (KBE) vs. REITs (IYR)
- Model Portfolio Update – May 8, 2015 COB: +0.67% WTD, +0.69% MTD, +1.31% YTD

Portfolio Overlay: S&P 500 Strangle

As a reminder, we have been directionally short of the S&P 500 from day one of this year via put options, either outright or in spread form.

On Friday afternoon, we adjusted the portfolio overlay strategy in the model portfolio to one based on “volatility” rather than “directional”.
The reason for that was very simple. We really no longer have a strong view on which direction the US stock market is heading over the next three months.

Rather than just holding a downside bias we are now open to the idea that the US equity market will break out of its current range (i.e. SPX 2110-2035) one way or the other.

Following the recent weaker US data (see next section below), the notion that the discount rate will remain closer to zero for longer is too hard to ignore and, as long as the Federal Reserve remains on hold, the disciples of the S&P 500 can-go-up-forever doctrine will feel more and more bold.

Additionally, we are mindful that we are now well into the fifth month of 2015. With the market a de-facto discounting mechanism six-months in advance, investors will soon begin to incrementally adjust their top-line earnings numbers for the S&P 500 for next year. At the end of that exercise, the over-valuation argument will get adjusted down incrementally as well.

This decision was not driven by emotions. With upside S&P 500 index call option volatility trading in the single digits (i.e. extremely cheap) it seemed responsible to add a position in order to protect the upside risk as well.

Collectively, these were the trades we implemented:

1. **Existing Position**: Sold 5,000 SPY 6/19/15 P205 at $1.87 to close.

2. **New Position**: Bought 10,000 SPY 9/18/15 200-185 put option spreads for $2.30 to open.
   a. Rolled down in strike and out to September from June expiration.
   b. Spent 75 bps of the NAV (i.e. 30 bps recycled from prev position + 45 bps added).
   c. Doubled the position to cover 200mm strike notional relative to the 300mm NAV.
   d. Downside break-even is ~5%.

3. **New Position**: Bought 10,000 SPY 9/18/15 C230 for $0.335 to open.
   a. In volatility terms, we lifted a 9.45 implied level, i.e. single digits!
   b. Spent ~11 bps of the NAV.
   c. Strike notional equates to 230mm relative to 300mm NAV.
   d. Upside break-even is ~9%, however
      i. The SPY 230 call option strike was the best risk-reward profile in a scenario analysis for all the S&P 500 strikes between 2200-2350.
      ii. In a scenario where the S&P 500 trades up to 2250 in the next 2 to 3 months our expected return is ~5x the premium outlay, and if the SPX trades to 2300 in the same time frame the expected return is ~10x.
The net result is that the model portfolio is now long outright volatility via a September S&P 500 strangle that has a 9% upside and 5% downside break-even level. Our desired outcome remains lower prices and for the S&P 500 to stop trading like Japanese JGB’s (i.e. a widow maker for shorts). But, like everyone else, we will see. The market won’t necessarily do what we would like it to.

**Side Bar:**

While we try to proactively educate readers in these pages, even while acknowledging many know just as much as we do or more, part of our discipline comes from the process of writing our thoughts down. At the very least, this should also give you some insight as to how we would budget risk and plan for contingencies.

A lot of people in this business, especially those that run long/short equity strategies, will tell you that they budget each year throwing away 2% of their NAV on protecting their overall portfolio. We have always found that to be a waste of money and with a little sophistication that book overlay cost can be brought down significantly. After all, this business is not always about making money, it is about saving money as well.

As part of our rules based discipline we look to spend no more than 120 bps per annum in the portfolio overlay return stream bucket. Additionally, unlike most others, we look to actually make money on this strategy rather than “set it and forget it”.

In 2015, we have largely used S&P 500 downside put option protection as the portfolio overlay. However, more recently we added in a euro currency and German Bund future call option strategy as well, given our core themes of short German Bunds versus long US Treasuries, and long the US dollar versus short the Swiss franc and Singapore dollar.

As of last Friday, between all three of these existing positions, we currently have ~105 bps of “unrealized” premium outlaid with ~85 bps of that ~105 bps risk not expiring until mid-September.

Additionally, in “realized” terms, we have already spent 99 bps year-to-date.

So if we add up our “realized” and “unrealized” premium, and assume the “unrealized” positions also went to zero in September, the total outlay would be ~204 bps and we would be well over the 120 bps we allocate to this portfolio overlay return stream.

So not only does that leave us exposed to breaking our own rule by a reasonable margin, but we would find ourselves in the unenviable position of having to spend even more money to protect the fourth quarter if we turn out to be wrong between now and the end of September.

The only salvation however, is that we have a much more powerful profile – that is, two-times the notional leverage and the upside is now protected in the S&P 500 as well, not just the downside as had been the case beforehand.

If the S&P 500 moves ~2% to the downside or ~4% to the upside, we will have plenty of chances to reduce the annualized premium outlay and bring this return stream back in line with our rules-based discipline. And in the process, at least we will have the option to participate in a bigger move while everybody else is chasing.
While we would not hesitate to aggressively manage the euro and bund call options to further bring the premium in line with our rule we would note that they are hedges to our core relative value positions, which have their own distinct profiles from a carry perspective.

**US Data Update**

This week there is going to be a “VaR shock” in the paid forecasting community. For the first time in years, as measured by quarterly GDP, Europe will show a stronger growth profile than the United States. Additionally, to put things into perspective, it is now possible in the last two quarters that growth in the Eurozone will outpace the US for only the fourth time since the Euro common currency was created (the other times that happened, in case you were wondering, were in 2001, 2007, and 2011).

Below are some generic charts for the US data.

The first one is the widely followed Citigroup Economic Surprise - United States Index. The second and third ones are the less followed, but better representation, Nomura USD Hard and Soft Data Surprise Indices.

For those not familiar with the difference, examples of "hard" data would include Existing Home Sales, Construction Spending and Retail Sales, to name just a few. "Soft" data is survey related and includes ISM Manufacturing, Philly Fed or University of Michigan Consumer Sentiment, to name a few.
As you can see there has been no bounce back in the hard data relative to expectations.

Additionally, here is our updated forward looking economic model that captures all of the “May” data. As a reminder, new orders and order backlogs are a leading indicator of future economic activity, as are higher levels of inventories. When inventories are rising and orders are falling, this is a cause for concern.

As you can see there has been a modest reversal in the pace of deceleration in the forward-looking measures, but it is still contractionary in aggregate.

Going into the job number on Friday, regardless of what you might have heard the whisper number was going to be, the paid forecasting community wanted to believe that the data would bail them out for their second quarter call where a repeat of last year’s profile in the data was expected.

The fact is the consensus call for a second quarter bounce has yet to materialize, and we are now halfway through that three-month period. At the same time, first quarter growth expectations, as measured by GDP, continues to be revised down to somewhere between -0.5% and -0.8%.

What this means is that the second quarter call of positive 3% to 4% growth (i.e. the expected strong rebound) is now going to be forecasted lower.

Collectively, with a second quarter profile sub-2%, and a first quarter profile of a trajectory still towards -1%, the first half growth profile will likely be well below trend and conclude closer to 1% growth, if not lower.

As much as we want to be inspired, there is just nothing to give us any encouragement at the moment.

The best representation of this for us is in the long March 2016 Eurodollar structure we established last week for 99.15, and closed the week up at 99.23 following the jobs data. While everybody else remains focused on when
the Federal Reserve is going to hike rates, we remain focused on the pace of those hikes – especially where asymmetry exists – and the data suggests there are too many hikes baked in for the next 18 months.

We also remain short the July 2015 Eurodollar future (EDNS5) on the chance that getting off the zero bound is more important than the growth profile, or the notion that the US dollar and energy prices are no longer a factor, plays an increasing role in their decision making. However, given what’s already occurred, if that were to happen, we would have a lot more “convexity” to that event given that the market is only pricing in a 10% probability of a hike by the July meeting, and the probability of a hike in June is now effectively zero.

For our EDN5 position, we consider this a 100 delta option on an interest rate hike at the June or July Federal Reserve meeting that risks another 7 bps of the NAV. At this point, if there was no hike our risk is one more basis point in the position. If there is a hike, we have a 24 to 1 payout. Don’t get us wrong, it is not that we think these instruments are mispriced, it is just that given our view that we do not think there will be an aggressive number of rate hikes over the next 12 months, if the June and July meetings pass without a hike then the probability of making a profit on the EDH6 leg substantially increases.

**US Financials (KBE) vs. REITs (IYR)**

In the April 30th edition of *Sight Beyond Sight* we highlighted a potentially significant theme and argued that investors are rotating into large cap banks on a new NIM story due to higher yields and economic stabilization in the second half of the year. Since then, including late last week, a number of analysts with very loud microphones have been out with formal calls suggesting a very similar view.

Despite the benign labor report last Friday, all 24 stocks in the KBW Bank Index (BKX) closed positive as the 5-30 year Treasury curve bull-steepened. For reference, the SPDR S&P Bank ETF (symbol: KBE) is the ETF equivalent of the BKX Index.

As much as we have sympathy for this sector move we are asking ourselves if getting long on US Financials is really the best approach when evaluating the opportunity set relative to other sectors or even other regions. Here is why.

Take a look at the ratio of the S&P 500 relative to the BKX Index.
Banks have outperformed REITs by ~25% since the February lows (left chart) when both US interest rates and the 5-30 Treasury yield curve bottomed out. At this point, the Banks are trading two standard deviations above REITs on the one-year regression line (right chart).

If you believe that the Federal Reserve is on hold in part due to the weak data as sketched out above and the search for yield will trump the net interest margin (NIM) argument on a steeper yield curve, then getting long on IYR and short of KBE makes more sense than just buying KBE outright on a relative rotation at the sector level.

For all the hype given to JPMorgan's new all-time high stock price on Friday the fact is that REITs outperformed large caps banks and the yield on IYR is 3.54% versus 1.58% for KBE.

If we were not already positioned this way via our interest rate strategies we would be adding this relative value pair to the model portfolio. We are just mindful of the correlation between asset classes.

Market Tidbits:

- **Fixed Income**: Denmark rejects all bids at its 14-week T-bill auction for the first time in four auctions. Bids can be rejected by the central bank in its effort to protect the EUR/DKK peg.

- **German Bunds**: Futures open interest reaches highest levels since November 2007.
  - There has been a 92.5% correlation between the price of front month Brent and 10-year German Bund yields since June. (@humenm, FT Commodities editor)

- **Crude Oil – WTI**: As WTI touched $45/bbl we saw the continued drop of drilling rigs, indicating a future drop of production as a WTI approached $65/bbl we started to this week more mentions by oil producers of bringing some rigs back, indicating a future rebound of US crude oil production. We can therefore define the range between $45 and $65 a barrel for WTI as the “shale band.” Selling below $45/bbl in WTI is selling into supply destruction and buying WTI above $65/bbl is buying into supply resurrection. In our opinion both of those trades offer currently a poor risk/reward for a sustained position. (Petromatrix, a Swiss-based independent research group that specializes in the oil markets)
  - **Baker Hughes Data**: Permian oil rigs gain for first time in 2015; next Baker Hughes rig count this week likely to be positive.
  - **Oil Services**: Downgrading Onshore Services. Take Profits & Take a Vacation; Downgrading RES, PTEN, WFT as well as NOV (Citigroup)

- **US Equities**: "The growth rebound should boost the S&P 500 to 2150 (+3%) in 2Q." (Goldman Sachs)
- **IMF on Germany Growth:** 2015 GDP growth could be above 1.6% forecast in April, if transmission of lower energy prices and ECB's QE are more powerful than expected; on Apr 14th IMF raised German 2015 GDP growth from 1.3% to 1.6%.
  - Europe tail-wind has turned (yield, energy prices & currency): Saxo Growth Indicator (Source: @Steen_Jakobsen)

![Graph of EUR/USD exchange rate]

- **Euro Exchange Rate:**
  - **EUR/USD** to trend to 1.05 on a 6m view on expectations that Fed could be hiking rates in Dec while ECB continues its QE program (Source: Rabobank)
  - "**It is time to Sell EUR/$:** the long-term bear trend is resuming. Sell EUR/$ at market (1.1167), risk 1.1395, target 1.0283" (Source: BAML, Technical Strategy, MacNeil Curry)

- **Technical Strategy:** Lee Oliver has left Citi where he was global head of the bank’s strategy and research service, CitiFX Wire. A former trader and financial journalist, Oliver joined Citi in 2010 to launch and manage CitiFX Wire. Sources familiar with the matter say that Citi will continue to provide the FXWire service.

- **BAML Chart of the Day:** With flatteners initiated since Sep14 and dollar longs since Mar15 underwater, more capitulation could be on the horizon. (Source: BAML, Liquid Insight)
China:

- The People's Bank of China (PBoC) cut its benchmark interest rates for 3rd time since November; the 25bps cuts will bring the one-year lending rate down to 5.1% and the equivalent deposit rate to 2.25%. The PBOC also raised the ceiling on deposit rates to 1.5 times the benchmark from 1.3 times, continuing its recent pattern of accompanying policy rate adjustments with reform of China's interest rate regime.

  - **Stealth Interest Rate Liberalization:** See if you can spot it given no one else has...
    - **Old:** Old deposit rate of 2.50% x old 1.3x ceiling = 3.25%
    - **New:** New Deposit rate of 2.25% x new 1.5x ceiling = 3.375%

- **IPO's:** The 23 IPO's last week attracted CNY3.2 trillion in subscriptions - a new high since the resumption of IPOs last January. The record was achieved despite the IPOs being smaller than previous offerings - suggesting investors' increasing interest in new shares. The stock-market regulator Friday approved another 20 IPOs for this month. (Shanghai Securities News, MNI)

- **Earnings:** Downgrades in China’s 2015E consensus EPS slowed to -0.2% in May, compared to -1.5% 6-month average. (Source: Credit Suisse APAC)
Asset allocation: Lower asset IRRs and the collapse in global productivity growth threaten the 6-year rally in global assets. Reduce exposure by bringing cash up to Neutral from Underweight. (JPMorgan, Global Asset Allocation, Jan Loeys)

- Equities: Open long in MSCI EM vs. MSCI World.

New Zealand: The New Zealand dollar (NZD) is showing the largest negative risk-adjusted return across regions and assets. The reaction follows ANZ revised view on RBNZ OCR. They now expect 25bps cut each in June and July saying lower currencies go hand in hand in the current market environment.

- "We've seen enough across our four prongs (high NZD, dairy income squeeze, inevitability of a prudential response towards housing and continued low core inflation reads) to call the OCR lower. Monetary policy is more than merely monitoring demand and wage and price setting outcomes; the RBNZ must manage the risk profile around them. Cutting the OCR is a low delta option to manage emerging risks," (Australia and New Zealand Banking Group Limited, Chief Economist, Cameron Bagrie)

- More cash-flow constraints across the dairy sector with prospects for the 2015-16 dairy payout weak.

- We shift from a trading to a structural short NZD bias and initiate a NZD/USD sell recommendation.

- We add a short NZD/USD trade recommendation entry of 0.7405 and targeting a new low of 0.7010, and a stop loss of 0.7610. We expect the NZD to underperform into the 11 June RBNZ meeting. This is in addition to our long AUD/NZD trade recommendation – initiated 23 April at 1.0230 and last updated 6 May, which we are happy to let run.

Iron Ore: “Market fundamentals will reassert themselves sooner rather than later; Investors may consider this as a window to take short positions.”; Maintains forecast for prices to average $52 a metric ton this year. (Source: GS, Christian Lelong and Amber Cai)
- Forecast for 2015 cut to $54/ton and 2016 reduced to $50/ton, down from $75 for both yrs; Steel-demand growth in China turned negative for 1st time in 2014; China’s steel industry may continue to see small contraction in 2015, before leveling off at zero growth for next few years (Source: Sanford C. Bernstein)
CURRENT THEMES

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<th>Tactical (T)</th>
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<td>Directional/Counter-Trend</td>
<td>Long US Dollar vs. Short Swiss Franc &amp; Singapore Dollar</td>
<td>X</td>
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<tr>
<td>Directional/Counter-Trend</td>
<td>Long Chinese H-Share Equities</td>
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<td>X</td>
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<tr>
<td>Directional/Counter-Trend</td>
<td>Long AAPL Capital Redeployment &amp; Upside Margins/EPS Guidance</td>
<td></td>
<td>X</td>
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<tr>
<td>Relative Value (Carry)</td>
<td>Long Brazil Stabilization/Carry vs. Japan Easing</td>
<td>X</td>
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<tr>
<td>Relative Value</td>
<td>Long European vs. Short US Equities Currency Hedged</td>
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<tr>
<td>Relative Value</td>
<td>Short European vs. Long US Fixed Income</td>
<td>X</td>
<td></td>
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<tr>
<td>Relative Value</td>
<td>June 2015 (T) vs. March 2016 (S) Pace of US Interest Rate Hikes</td>
<td>X</td>
<td>X</td>
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<tr>
<td>Technical/Mean Reversion</td>
<td>Long Silver vs. Short Gold</td>
<td>X</td>
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<tr>
<td>Idiosyncratic</td>
<td>US Equity - Google - Dividend Conversion Arbitrage</td>
<td>X</td>
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<tr>
<td>Risk Premium</td>
<td>Extraction of US Interest Rate Risk Premium</td>
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<td>Portfolio Overlay</td>
<td>Long German Bund Call Option</td>
<td>X</td>
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<tr>
<td>Portfolio Overlay</td>
<td>Long US Equity Volatility (via S&amp;P 500 Strangle)</td>
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<tr>
<td>Portfolio Overlay</td>
<td>Long Euro exchange rate (via EUR/USD call options)</td>
<td>X</td>
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*Source: Rareview Macro.

WATCH LIST

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<tr>
<th>Asset Class</th>
<th>Entry Date</th>
<th>Strategy</th>
<th>Return Stream</th>
<th>Wake Up Price</th>
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<tbody>
<tr>
<td>Equities</td>
<td>05-Jan-15</td>
<td>Long Euro Stoxx 50 Index Dividend Futures (2017, DEDZ7)</td>
<td>Risk Premium</td>
<td>€102.00</td>
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<tr>
<td>Credit</td>
<td>05-Jan-15</td>
<td>Long 5-Yr Credit Default Swap (CDS) on Brazil</td>
<td>Portfolio Overlay</td>
<td>175-200 bps</td>
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*Source: Rareview Macro.

RISK EXPOSURE

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<tr>
<th>Risk Level</th>
<th>% of Portfolio</th>
<th>Asset Class</th>
<th>Gross Exposure</th>
<th>Net Exposure</th>
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</thead>
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<tr>
<td>Medium</td>
<td>81.79%</td>
<td>Equities</td>
<td>$248,579,504</td>
<td>$36,448,570</td>
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<td>Medium</td>
<td>44.51%</td>
<td>Foreign Exchange (USD)</td>
<td>$135,264,676</td>
<td>$76,948,508</td>
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<td>High</td>
<td>0.21%</td>
<td>Fixed Income (DV01)</td>
<td>$650,000</td>
<td>(50,000)</td>
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<td>Medium</td>
<td>20.22%</td>
<td>Commodities</td>
<td>$61,468,181</td>
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<td>Low</td>
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<td>Credit (SV01)</td>
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<td>$ -</td>
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<tr>
<td>Low</td>
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<td>Option Premium (&lt;1-mo.)</td>
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PERFORMANCE UPDATE

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<th>Portfolio</th>
<th>Macro Strategy</th>
<th>Start NAV</th>
<th>End NAV</th>
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</thead>
<tbody>
<tr>
<td>2015 Year to Date Return</td>
<td>1.31%</td>
<td>$300,000,000</td>
<td>$303,922,257</td>
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<tr>
<td>2015 Month to Date Return</td>
<td>0.69%</td>
<td>Net $</td>
<td>3,922,257</td>
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<tr>
<td>2015 Week to Date Return</td>
<td>0.67%</td>
<td></td>
<td></td>
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</tbody>
</table>

| 2014 Year to Date Return | 17.81% | $113,160,023 | $133,310,565 |
| 2014 Sharpe Ratio | 1.92 | Net $ | 20,150,542 |
| 2013 Year to Date Return | 13.16% | $100,000,000 | $113,160,023 |
| 2013 Sharpe Ratio | 2.73 | Net $ | 13,160,023 |


Model Portfolio

For important information, including past performance, our process, FAQs regarding how the model portfolio is administered, and disclaimers please click [HERE](#). The portfolio illustrations referenced within this material are hypothetical. No actual investments have been implemented and any references to transactions, positions, gains, or loses with respect to the portfolio are hypothetical.
CHINA
- CPI YoY Apr:  +1.5% vs. 1.6% exp vs. 1.4% prior (4-month high)
- PPI YoY Apr:  -4.6% vs -4.5% exp vs. -4.6% prior (38\textsuperscript{th} straight month of decline)

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